

Court Finds That Payment on Aircraft Lease Security Deposit Letters of Credit Would Not Have Violated the United Kingdom's Sanctions Against Russia

March 30, 2023

KEY POINTS

- A court in London has ruled that the London branch of a German bank, which had issued confirmations of letters of credit issued by a Russian bank as security provided by Russian airlines for leases of aircraft, could have honored the drawing of the letters of credit by the lessors without violating the United Kingdom's sanctions against Russia and without the need to obtain a license from the UK government to make the payments pursuant to the letters of credit.
 - The court analyzed the relevant sanctions imposed by the UK prohibiting financial transactions involving Russian entities, and found that did not apply to the obligation of the confirming bank to make the payments.
-

Background

This advisory relates to letters of credit securing the obligations of Russian airlines under aircraft leases. Typically, the lease of an aircraft to any but a top-tier credit airline will require that the airline provide the lessor at the inception of the term of the lease either a cash security deposit in the amount of two months' basic rent or an irrevocable standby letter of credit drawable in the same amount issued by a bank whose jurisdiction and creditworthiness are satisfactory to the lessor. If the airline wishes to have the letter of credit issued by its local relationship bank, the airline and local bank will arrange for a more creditworthy bank in a location such as London or New York to issue a confirmation of the letter of credit. The result is that the lessor will be able to draw on the confirmation as though the confirming bank had issued the letter of credit. The local bank will then have an obligation to reimburse the confirming bank, and the airline an obligation to reimburse the local bank, for any drawing by the lessor.

An aircraft lease will list various events of default. The events of default will typically include, in addition to the failure to pay rent, such events as the leasing of the aircraft or the lessee's performance under the lease becoming illegal including through the imposition of government sanctions against the airline or its home country. The lease will also list the remedies that the lessor may exercise if an event of default occurs and is continuing. If the airline's obligations under the lease are secured by a cash security deposit, the lease will provide that the lessor may apply

it to the damages resulting from each event of default. If the airline's obligations are instead secured by a letter of credit, the lease will provide that the lessor may present the letter of credit or confirmation at the issuing bank or confirming bank as applicable, with a demand that the bank pay a specified amount not greater than the lesser of the face amount of the letter of credit and the damages incurred by the lessor.

On February 24, 2022, Russia invaded Ukraine. The European Union responded one day later with a package of sanctions against Russia which, among other things, made the leasing of aircraft by EU-domiciled lessors to Russian airlines illegal. The United Kingdom and United States (and other jurisdictions) issued their own sanctions packages. The sanctions and later sanctions packages also, among other things, prohibited various financial transactions for the benefit of or connected to various Russian banks and other persons and entities.

The Decision in the Current Cases

On March 23, the High Court of Justice, Commercial Court, in London handed down a [decision](#) in regard to two separate lawsuits (with similar fact patterns) brought by Irish aircraft lessors against the London branch of a German bank (the LC Confirming Bank). In each case, the LC Confirming Bank had provided the lessor an English-law confirmation (each, an LC) of a security deposit letter of credit issued by a Russian bank to the lessor as collateral for the obligations of a Russian airline under the lease for a commercial aircraft. Each LC was payable in US dollars. Each lease had been entered into, and the LC Confirming Bank had issued the LCs, well before Russia invaded Ukraine on February 24, 2022. In response to the invasion, the European Union, the United Kingdom, and the United States (among others) imposed sanctions against Russia which effectively barred the continued leasing of aircraft to Russian airlines. The sanctions triggered events of default under each lease. The occurrence of the events of default entitled each lessor to exercise remedies, including drawing on each of its LCs. In March 2022, each lessor drew on the relevant LC by submitting a demand for payment to the LC Confirming Bank in the manner provided in the LC. The LC Confirming Bank declined to honor the drawings on the LCs on the grounds that it was prohibited from doing so by reason of the operation of sanctions affecting Russia issued by the UK, the EU and the United States. The LC Confirming Bank acknowledged that in the absence the sanctions, it would have honored the drawings and paid the lessors the amounts demanded. The sanctions schemes provided that the applicable government agency could upon application issue a waiver in an appropriate case to permit an activity not otherwise permitted by the sanctions. The LC Confirming Bank applied to the relevant agencies in the UK, the EU, and the United States for licenses to make payment under the LCs. The LC Confirming Bank received licenses from the UK and EU agencies and made payment on certain LCs. While the LC Confirming Bank's application for a license from the US agency was pending, the LC Confirming Bank and the lessors settled certain of the LCs by making payment in sterling rather than in US dollars to an account in London at a non-US bank. (Why the LC Confirming Bank made payment on some but not all LCs in US dollars and only offered to settle the others in sterling is not explained in the opinion).

Although the parties reached agreement on the payment of the drawing amounts under the LCs, there still remained the open issue of costs and interest to be awarded to the lessors. This in turn required that the court determine whether the LC Confirming Bank required the UK licenses in order to honor the drawings, or could have made payment under the LCs all along. The court also looked briefly at the applicability of the EU sanctions and, because the LCs were payable in US dollars, US sanctions.

The UK Sanctions

The UK law the court principally considered consisted of three regulations issued under the Russia (Sanction) (EU Exit) Regulations 2019 No. 855, as amended: Regulation 28, Regulation 13 and Regulation 11.

Regulation 28 concerned the provision of financing for the supply of restricted goods or technology to Russia. Specifically, Regulation 28(3) prohibited providing financial services or funds in pursuance of or in connection with an arrangement whose object or effect is the supply of restricted good to, or for use in, Russia, or to a Russian person. The issue here was whether the payment under the LCs would be in pursuance of or in connection with the supply of aircraft under the leases to the Russian airlines.

The court found that Regulation 28 did not relieve the LC Confirming Bank of its obligation to make payment to the lessors under the LCs. The court started with the purpose of the regulation: to ensure that financial assistance was not provided to Russian parties in relation to the supply of aircraft, among other things. The court found that the regulation operated prospectively and not retrospectively. If the LCs had been issued to enable the supply of an aircraft to a Russian party after the date on which the regulation came into force, the LCs would have been prohibited. But the aircraft had been supplied to the airlines in Russia, and the LCs issued, before the Regulation came into effect. Once the Regulation came into effect, all that remained to be done was for the LCs to be paid. That benefited the lessors only, not the Russian letter of credit issuer or the airlines. Payment under the LCs would have the collateral effect of discharging the obligations of the airlines and the Russian letter of credit issuer to the lessors. But the Russian issuer would remain liable to reimburse the LC Confirming Bank. And the airlines would remain liable to reimburse the Russian issuer. So the Russian parties would not benefit from the payment of the LCs.

Similarly, the court found that Regulation 11, which prohibits dealing with funds or other economic resources owned, held or controlled by a sanctioned entity, did not prohibit the LC Confirming Bank from honoring the LCs. The original letter-of-credit issuing bank was sanctioned under Regulation 11, but not until April 6, 2022, after the lessors had drawn on the LCs. In any case, the LC Confirming Bank would not be dealing with the Russian bank's property by honoring the LCs. The LC Confirming Bank would instead be performing its own independent contractual obligation. The Russian bank's own property was not affected.

Similarly, the court rejected claims under Regulation 13, which prohibits making funds available to a sanctioned entity. The payment by the LC Confirming Bank would not make funds available to the Russian bank or lead to the discharge of any obligation of the Russian bank, but merely shift it from an obligation of the Russian bank in favor of the lessor to a reimbursement obligation of the Russian bank in favor of the LC Confirming Bank. Also, as with Regulation 11, the Russian bank did not become a sanctioned entity under Regulation 13 until April 6, 2022, after the lessors had drawn on the LCs.

Because the court found that honoring the LCs would not violate UK sanctions, the court also found that it was not necessary for the LC Confirming Bank to obtain licenses in the UK before honoring the LCs. A license is necessary only if the conduct is prohibited in the first place.

Reluctantly, the court opined briefly on US sanctions, and found that the LC Confirming Bank had not met its burden of showing the US sanctions were in place at the time its payment was due, which would have made its payment under the letters of credit confirmations illegal.

The court reached no conclusions on EU sanctions, which were outside its jurisdiction but may be relevant given that the LC Confirming Bank is the London branch of a German bank.

Conclusion

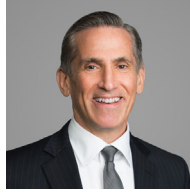
As the court pointed out, this decision is relevant because it gives guidance to other aircraft lessors and letter-of-credit issuers or confirming banks as to whether a the drawing on a security deposit letter of credit issued to a lessor of an aircraft to a Russian airline may be honored without violating sanctions. Although there will be many facts in common with other leases of aircraft to Russia in which the lessor drew on a security deposit letter of credit following the invasion of Ukraine, the decision here is fact specific and does not materially address sanctions in the European Union or the United States. Therefore each situation should still be analyzed carefully on its own.

CONTACTS

For more information, please contact your Katten attorney or any of the following members of the firm's [Aviation](#) group:



Timothy J. Lynes
+1.202.625.3686
timothy.lynes@katten.com



Stewart B. Herman
+1.212.940.8527
stewart.herman@katten.com



Timothy J. Kirby
+1.212.940.6494
tim.kirby@katten.com



Chris Harrison
+44 (0) 20 7776 7623
christopher.harrison@katten.co.uk



Charlotte Sallabank
+44 (0) 20 7776 7630
charlotte.sallabank@katten.co.uk



Katya Harrison
+44 (0) 20 7770 5242
ekaterina.harrison@katten.co.uk



Brett J. Seifarth
+1.202.625.3615
brett.seifarth@katten.com

Katten

katten.com

CENTURY CITY | CHARLOTTE | CHICAGO | DALLAS | LONDON | LOS ANGELES | NEW YORK | ORANGE COUNTY | SHANGHAI | WASHINGTON, DC

Attorney advertising. Published as a source of information only. The material contained herein is not to be construed as legal advice or opinion.

©2023 Katten Muchin Rosenman LLP. All rights reserved.

Katten refers to Katten Muchin Rosenman LLP and the affiliated partnership as explained at [kattenlaw.com/disclaimer](#).

3/30/23